



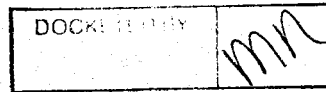
BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

Arizona Corporation Commission
DOCKETED

JAN 23 2008

MIKE GLEASON - Chairman
WILLIAM A. MUNDELL
JEFF HATCH-MILLER
KRISTIN K. MAYES
GARY PIERCE



IN THE MATTER OF THE APPLICATION OF
UTILITY SOURCE, L.L.C. FOR A
DETERMINATION OF THE CURRENT FAIR
VALUE OF ITS UTILITY PROPERTY AND FOR
AN INCREASE IN ITS WATER AND
WASTEWATER RATES AND CHARGES FOR
UTILITY SERVICE.

DOCKET NO. WS-04235A-06-0303

DECISION NO. 70140

OPINION AND ORDER

DATES OF HEARING:

November 28, 2006 (Procedural Conference), April 13, 2007 (Prehearing Conference); June 19 and 20, 2007.

PUBLIC COMMENTS:

January 22, 2007¹ (Phoenix); March 19, 2007² (Flagstaff)

PLACE OF HEARING:

Phoenix, Arizona

ADMINISTRATIVE LAW JUDGE:

Teena Wolfe

IN ATTENDANCE:

Mike Gleason, Chairman
William A. Mundell, Commissioner
Kristin K. Mayes, Commissioner
Gary Pierce, Commissioner

APPEARANCES:

Mr. Richard L. Sallquist, SALLQUIST, DRUMMOND & O'CONNOR, on behalf of Utility Source;

Mr. Starr Lamphere in pro persona;

Mr. David Hitesman, in pro persona;

Mr. Dennis Jones, in pro persona; and

Mr. Charles Hains, Staff Attorney, Legal Division, on behalf of the Utilities Division of the Arizona Corporation Commission.

¹ Assistant Chief Administrative Law Judge Dwight Nodes held the January 22, 2007, public comment session.

² The Commissioners held the March 19, 2007, public comment session.

BY THE COMMISSION:

On May 1, 2006, Utility Source, LLC ("Utility Source" or "Company") filed with the Arizona Corporation Commission ("Commission") an application for a determination of the current fair value of its utility plant and property and for increases in its rates and charges for water and wastewater utility service provided to customers in the Company's service area, located approximately eight miles west of Flagstaff, near Bellemont in Coconino County, Arizona.

Following the filing of additional information by the Company, the Commission's Utilities Division Staff ("Staff") found the application sufficient on July 3, 2006, and classified the Company as a Class C utility.

By Procedural Order issued July 10, 2006, a hearing in this matter was scheduled for January 22, 2007, and other procedural deadlines were established.

By Procedural Order issued December 20, 2006, the hearing date was continued to April 3, 2007, and the timeclock in this matter was extended accordingly.

Intervention was granted to Mr. Starr Lamphere, Mr. David Hitesman, and Mr. Dennis Jones.

On January 22, 2007, at the time and place noticed for the hearing, an opportunity for public comments was provided. The Company and Staff appeared through counsel. No members of the public appeared.

On March 19, 2007, a public comment hearing was held by Commissioners at the Coconino County Board of Supervisors Meeting Room in Flagstaff, Arizona. Members of the public attended, and several customers of the Company provided their comments on the application.

By Procedural Order issued on March 16, 2007, the hearing date was continued to May 1, 2007. Following the pre-hearing conference held on April 13, 2007, the hearing date was continued to May 2, 2007.

On April 27, 2007, the Company filed a Motion for Continuance due to unavailability of counsel. On April 30, 2007, a Procedural Order was issued continuing the hearing to June 19, 2007, and suspending the applicable timeclock during the continuance.

The hearing commenced as scheduled on June 19, 2007, before a duly authorized Administrative Law Judge of the Commission. The Company and Staff appeared through counsel

1 and presented evidence. Intervenor Mr. Starr Lamphere, Mr. David Hitesman, and Mr. Dennis
2 Jones appeared, each on his own behalf. Following the filing of post-hearing briefs by Utility Source,
3 Staff, and Mr. David Hitesman, and other post-hearing filings, the matter was taken under advisement
4 pending the issuance of a Recommended Opinion and Order for consideration by the Commission.

5 DISCUSSION

6 **A. BACKGROUND**

7 The Commission ordered Utility Source to file this rate application in Decision No. 67446
8 (January 4, 2005), which granted the Company its Certificate of Convenience and Necessity (CC&N)
9 and set water and sewer rates. Utility Source began as a homeowners' association, controlled by the
10 developer. The homeowners' association installed utility facilities, provided water and utility
11 services, and established rates without first having obtained authority from the Commission to do so.
12 Decision No. 67446 imposed a penalty of \$20,000, and ordered that all the assets used in the
13 provision of utility service be transferred to the Company. Decision No. 67446 found that increasing
14 rates to a level commensurate with the Company's projected revenues, expenses, and number of
15 customers at the end of five years of operations, as is customary with new CC&N applications, would
16 result in an unconscionable increase for existing customers (Decision No. 67446 at 16, Findings of
17 Fact No. 31). Decision No. 67446 also found that customers had not been provided notice in the
18 CC&N proceeding that higher rates might result (*Id.* at 16, Findings of Fact No. 32). Decision No.
19 67446 therefore authorized the Company to continue charging the water and sewer rates that the
20 homeowners' association had been charging, finding that "[t]he initial rates for Utility Source should
21 therefore be set at the current level until an investigation can be undertaken in a full rate case to
22 determine the cost of plant that is used and useful in the provision of service to customers, as well as
23 an appropriate level of revenues and expenses" (Decision No. 67446 at 16, Findings of Fact. No. 32).
24 While Decisions granting CC&Ns usually order the Company to file a rate case at the end of the first
25 five year period of operations, Decision No. 67446 ordered the Company to file a rate application
26 based on a 2005 test year within 17 months, due to the interim nature of the initial rates authorized by
27 the Decision (Decision No. 67446 at 18, Findings of Fact No. 37).

28 Decision No. 67446 made specific findings regarding the rates illegally set by the developer

1 of Flagstaff Meadows, the development that is served by Utility Source. The Decision stated that it
 2 appeared that the developer induced customers to purchase homes with water and wastewater rates
 3 insufficient to support the construction and long-term operations of water and wastewater systems for
 4 the planned development (Decision No. 67446 at 11, Findings of Fact No. 26). The Commission
 5 ordered the Company to notify its customers that the Company had commenced operations without
 6 Commission authorization, and that higher rates for customers would likely result in the future due to
 7 the Company's actions (*Id.* at 18, Findings of Fact No. 38). In compliance with the requirements of
 8 Decision No. 67446, on February 2, 2005, the Company mailed the following notice to its customers:

9 **PLEASE READ**
 10 **UTILITY SOURCE, LLC**

11 **IMPORTANT NOTICE REGARDING WATER**
 12 **AND WASTEWATER RATES**

13 On January 4, 2005, the Arizona Corporation Commission ("Commission") approved
 14 Utility Source, LLC's (the "Company") request to provide water and wastewater
 15 service to the Flagstaff Meadows Development. Although the Commission [had] not
 16 authorized the Company to provide those services, the water and wastewater rates
 17 currently in effect were not approved by the Commission, because the Company
 18 commenced operations without Commission authority. Therefore, the setting of initial
 19 rates that support the construction and long-term operations of water and wastewater
 20 systems for the planned development occurred without Commission authority. The
 21 current rates were artificially set by the Company and may not be sufficient to cover
 22 the on-going costs of providing service. Therefore, in an attempt to balance equities
 23 between the Company and its customers and to provide adequate notice, the
 24 Commission has required the Company to file a rate application by May 1, 2006, that
 25 may result in higher rates. Customers will be given notice of that filing when made,
 26 which shall include the Commission Staff's estimate of proposed rate levels. You will
 27 have an opportunity to be heard before the Commission regarding that application.

28 (Affidavit of Mailing docketed on February 3, 2005, in Docket No. WS-04235A-04-0073).

Decision No. 67446 denied the Company's request for approval of a hook-up fee tariff, noting
 the following:

[T]he utility company and the developer are one and the same, and the developer has,
 to this point, apparently chosen to install the entirety of the system without using
 advances or contributions, thereby inflating the Company's rate base and thus rates
 that may ultimately be paid by customers. We believe it is inappropriate to allow the
 Company/developer to benefit further from imposition of hook-up fees where the
 Company has made no effort to mitigate the potential rate effect on customers through
 the use of main extension agreements allowed under Commission rules.

1 (Decision No. 67446 at 8, Findings of Fact No. 16).

2 Decision No. 67446 also denied the Company's request for long-term debt, stating the
3 following:

4 Utility Source has not availed itself of the opportunity to negotiate main extension
5 agreements but by its actions has, instead, pursued a development strategy that will
6 potentially have the effect of saddling the Company's customers with unduly
7 burdensome rates. We do not believe it is appropriate to add an additional financial
8 burden on the Company's customers by approving a financing proposal that further
insulates the utility company/developer from risk.

8 (Decision No. 67446 at 9, Findings of Fact No. 21).

9 **B. APPLICATION**

10 Utility Source filed its rate application on May 1, 2006. Staff found the application sufficient
11 on July 3, 2006, following Utility Source's provision of supplemental information. The application is
12 based on a test year ending December 31, 2005. At the end of the test year, the Company served 337
13 customers through its Water Division and its Sewer Division.

14 **1. Water Division**

15 For its water division, the application requested a revenue increase of \$401,166, or a 230.03
16 percent increase over test year adjusted operating income of (\$77,896). Utility Source later amended
17 its request to a revenue increase of \$312,361, or a 179.18 percent increase over test year adjusted
18 operating income of (\$23,286). Staff recommends a revenue increase of \$192,858, or a 110.63
19 percent increase over adjusted test year operating income of (\$21,340).

20 **2. Sewer Division**

21 For its sewer division, the application requested a revenue increase of \$187,117, or a 164.27
22 percent increase over test year adjusted operating income of (\$40,014). Utility Source later amended
23 its request to a revenue increase of \$139,654, or a 122.61 percent increase over adjusted test year
24 operating income of (\$22,959). Staff recommends a revenue increase of \$121,549, or a 106.71
25 percent increase over adjusted test year operating income of (\$22,441).

26 **C. RATE BASE**

27 Staff recommends, and the Company has accepted, several disallowances from the
28

Company's proposed plant in service for its water and sewer divisions, based on lack of substantiation of the used and usefulness of plant at the end of the test year.

1. Water Division

The Company proposes an adjusted original cost rate base ("OCRB") of \$2,753,096 for its water division. The Company did not file reconstruction cost new less depreciation ("RCND") schedules. The Company's proposed OCRB includes its Deep Well Number Four in plant in service. Staff presented three separate scenarios for consideration. Staff recommends that the Commission adopt its Scenario One, which includes the Company's Deep Well Number Four in plant in service, for an adjusted OCRB of \$2,753,095. Staff's Scenario Two includes the same adjusted OCRB of \$2,753,095, and Staff's Scenario Three excludes Deep Well Number Four from plant in service, with an adjusted OCRB of \$2,053,793.

a. Plant in Service

Staff's engineering analysis found that Deep Well Number Four was not used and useful during the test year. The Company does not dispute this finding. However, the Company proposes to include the \$736,583 cost of Deep Well Number Four in plant in service in conjunction with a revenue requirement reduction proposal. The Company proposes to add pro forma revenues to actual test year revenues, in order to reduce its revenue requirement in this case. The proposed pro forma revenues are equivalent to an amount that would be received if 350 additional customers had existed in the test year. Inclusion of those pro forma revenues, along with inclusion of Deep Well Number Four in rate base, would have the effect of a lower rate increase than would otherwise be required. The Company believes that if the pro forma revenues are included, it is equitable to also include Deep Well Number Four in plant in service. The Company explains that its proposal to include the well in plant in service is equitable because it will be necessary to use Deep Well Number Four to serve actual new customers when they become connected to the system and begin using water and providing actual revenues to the Company.

Staff supports the Company's proposal, and advocates for the adoption of Staff's Scenario One, which includes Deep Well Number Four and the pro forma test year revenues from 350

1 customers who will one day be served by that well.³

2 The Company asserts that its proposal to include Deep Well Number Four in rate base, along
3 with pro forma revenues from 350 future customers, will benefit current customers by spreading costs
4 over an artificially larger customer base than currently exists. The Company's witnesses testified that
5 when the impact of the revenue requirement based on the test year number of customers was
6 calculated, the Company was dissatisfied with the effect on customer rates (Tr. at 38). The
7 Company's managing member, Mr. Lonnie McCleve, testified that in order to reduce the rate impact,
8 the Company decided to include a pro forma adjustment to revenues to include revenues it expected
9 to receive when Flagstaff Meadows Unit 3 is built and the customers from that development begin
10 taking service (Tr. at 38). Mr. McCleve stated that while the Company used 350 customers to
11 estimate the pro forma revenues, the actual number of customers in Flagstaff Meadows Unit 3 will
12 actually be fewer, closer to 270 (*Id.* at 39). The Company's accounting witness testified that without
13 the pro forma revenues proposed by the Company, the rate increase necessary to reach the
14 Company's revenue requirement would be over 300 percent (Tr. at 85). The Company believes that
15 the effect of including both Deep Well Number Four and the pro forma revenues matches revenues,
16 expenses, and plant, and that its proposal is consistent with the concept of gradualism in changes to
17 customers' rates in order to avoid rate shock.

18 Under the unique circumstances of this case, we find the Company's proposal to include Deep
19 Well Number Four in plant in service, in conjunction with the Company's proposal to add pro forma
20 revenues from 350 customers to test year revenues in order to reduce the Company's revenue
21 requirement, and therefore the rate impact on current customers, to be reasonable, and will adopt it.
22 We agree with the Company and Staff that if the pro forma revenues are included in the test year
23 revenues, it is proper to also include in rate base the cost of Deep Well Number Four, which will be
24 required to serve the customers when they come on line. The plant in service balance for the
25 Company's water division is therefore \$3,195,818, which, with accumulated depreciation of

26 ³ Staff's Scenario Two also includes the Company's Deep Well Number Four in plant in service, whereas Staff's Scenario
27 Three excludes Deep Well Number Four and also excludes the pro forma test year revenues. As discussed in the Fair
28 Value Rate of Return section of the discussion below, in light of the significant rate impact of this case for the Company's
customers, Staff is also recommending, in its Scenario One, a downward adjustment to the fair value rate of return for the
Company's water division, in addition to inclusion of the 350 pro forma customers proposed by the Company.

1 \$164,185, results in a net plant in service balance of \$3,031,633.

2 **b. Contributions in Aid of Construction**

3 The Company's proposed rate base for the water division includes contributions in aid of
4 construction ("CIAC") in the amount of \$294,745, with accumulated amortization of \$16,207, for a
5 balance of \$278,538. This amount is not in dispute and will be adopted.

6 **c. Water Division OCRB**

7 Subtracting the CIAC balance of \$278,538 from the net plant in service balance of \$3,031,633
8 results in an OCRB for the Company's water division of \$2,753,095.

9 **d. Water Division FVRB**

10 The Company did not file RCND schedules, and we find that the water division's OCRB is its
11 fair value rate base ("FVRB"). The Company's FVRB for its water division is \$2,753,095.

12 **2. Sewer Division**

13 The Company proposes an adjusted OCRB of \$1,111,382 for its sewer division. Staff
14 recommends an adjusted OCRB of \$1,113,582.

15 **a. Plant in Service**

16 The Company and Staff agree on a gross plant in service balance of \$1,379,092. Staff
17 recommends an adjusted accumulated depreciation balance of \$79,962, and a net plant in service
18 balance of \$1,299,130, while the Company proposes an adjusted accumulated depreciation balance of
19 \$82,161, and a slightly different net plant in service balance of \$1,296,931. The Company accepted
20 Staff's recommended downward adjustment to the Company's Treatment and Disposal Equipment
21 account in the amount of \$216,389, but its schedules disagree with Staff's accompanying downward
22 adjustment in the amount of \$16,229 to the Company's proposed accumulated depreciation balance
23 of \$96,191, showing an adjustment of \$14,030 instead. In an April 11, 2007, filing, Staff stated that
24 the Company's accumulated depreciation amount was in error, and noted a disaccord in the
25 depreciable plant balances on the Company's rejoinder schedules. While neither party addressed the
26 discrepancy between the parties' computations of accumulated depreciation on brief, it appears to
27 stem from the unexplained disaccord in depreciable plant balances appearing in the Company's
28 rejoinder schedules. Staff's proposed net plant in service balance of \$1,299,130 for the Company's

1 sewer division corrects for that balance, and will be adopted.

2 **b. Contributions in Aid of Construction**

3 The Company and Staff are in agreement on the Company's proposed CIAC in the amount of
4 \$197,973, with accumulated amortization of \$12,425, for a net CIAC balance of \$185,548.

5 **c. Sewer Division OCRB**

6 Subtracting the CIAC balance of \$185,548 from the net plant in service balance of \$1,299,130
7 results in an OCRB for the Company's sewer division of \$1,113,582.

8 **d. Sewer Division FVRB**

9 The Company did not file RCND schedules, and we find that the sewer division's OCRB is
10 its FVRB. The Company's FVRB for its sewer division is \$1,113,582.

11 **D. REVENUES**

12 **1. Water Division**

13 The Company's proposed test year adjusted revenues for its water division of \$174,328
14 include \$83,560 of pro forma revenues from 350 future customers. Staff supports the Company's
15 proposal to include the pro forma revenues, along with the inclusion of existing plant in rate base that
16 will be necessary to serve those customers, as discussed above. Under the circumstances of this case,
17 in order to alleviate the rate impact that would result without the two-part proposal, we will adopt test
18 year adjusted revenues for the Company's water division of \$174,328.

19 **2. Sewer Division**

20 There is no disagreement between the Company and Staff for test year adjusted revenues for
21 the Company's sewer division of \$113,905, and this amount will be adopted.

22 **E. EXPENSES**

23 **1. Water Division**

24 The Company proposes total operating expenses for its water division of \$197,613, while
25 Staff recommends \$195,667. There is no disagreement between the Company and Staff for test year
26 expenses for Utility Source's water division other than the amount of property tax expense. The
27 Company's property tax expense estimate is higher than Staff's based on the Company's proposed
28 revenue requirement, which is higher than Staff's due to the Company's higher proposed fair value

1 rate of return ("FVROR"). Other than property tax expense, the test year expenses as proposed by
2 the Company are reasonable and will be adopted. Because we are adopting the Staff's FVROR
3 recommendation, for the reasons discussed further below, we adopt Staff's recommended property
4 tax expense level, for total test year operating expense of \$195,667 for Utility Source's water
5 division.

6 **2. Sewer Division**

7 The Company proposes total operating expenses for its sewer division of \$136,864, while
8 Staff recommends \$134,871. As with the water division, there is no disagreement between the
9 Company and Staff for test year expenses for the sewer division other than the amount of property tax
10 expense. The Company's property tax expense estimate is higher than Staff's based on the
11 Company's proposed revenue requirement, which is higher than Staff's due to the Company's higher
12 proposed FVROR. Other than property tax expense, the test year expenses as proposed by the
13 Company are reasonable and will be adopted. Because we are adopting the Staff's FVROR
14 recommendation, for the reasons set forth further below, we adopt Staff's recommended property tax
15 expense level, for total test year operating expense of \$134,871 for Utility Source's sewer division.

16 **F. COST OF CAPITAL**

17 **1. Capital Structure**

18 The Company and Staff agree that an appropriate capital structure in this case is the
19 Company's actual capital structure of 100 percent equity.

20 **2. Cost of Equity**

21 The cost of equity component of a cost of capital determination must be estimated. Both the
22 Company and Staff provided estimates arrived at through use of financial models. The Company
23 recommended a cost of equity of 10.5 percent. Staff recommended a cost of equity of 8.9 percent.

24 **a. Company**

25 The Company's cost of capital witness, Thomas J. Bourassa, recommended that the Company
26 be granted a 10.5 percent cost of capital and rate of return. He based his recommendation on the
27 results of his discounted cash flow ("DCF") analysis, his risk premium analysis, and his comparable
28 earnings analysis performed on a proxy group of companies that includes American States Water,

1 Aqua America, California Water, Connecticut Water Services, Middlesex Water, and SJW
2 Corporation. Mr. Bourassa performed three DCF analyses: a constant growth (earnings growth)
3 analysis, with results in a range from 9.7 percent to 12.0 percent, and a midpoint of 10.9 percent; a
4 constant growth (sustainable growth) analysis, with results in a range from 8.2 percent to 10.5
5 percent, and a midpoint of 9.4 percent; and a two-stage growth model, with results in a range from
6 9.2 percent to 11.5 percent, and a midpoint of 10.4 percent. Mr. Bourassa performed two risk
7 premium analyses: one using actual returns, with the result of 10.2 percent; and one using authorized
8 returns, with results in a range from 10.8 percent to 11.3 percent, with a midpoint of 11.1 percent.
9 Mr. Bourassa's two comparable earnings analyses yielded results as follows: using actual returns, his
10 results ranged from 4.2 percent to 11.7 percent, and a midpoint of 8.0 percent; using authorized
11 returns, his results ranged from 9.9 percent to 12.7 percent, with a midpoint of 11.3 percent. Mr.
12 Bourassa also provided Value Line Investment Survey's Industry Composites for 2006 (9.0 percent);
13 for 2007 (10.0 percent), and for 2009 (10.5 percent).⁴

14 For his DCF models, the Company's witness used analysts' forecasts of earnings per share
15 ("EPS") growth for the near term and average long-term gross domestic product ("GDP") growth,
16 using the arithmetic mean, for the long term. Mr. Bourassa testified that he chose not to use
17 forecasted dividend per share ("DPS") growth in his DCF model, because "[w]hen forecasted
18 dividend growth is used in the DCF model, it produces a cost of equity below the cost of debt"
19 (Direct Testimony of Thomas J. Bourassa at 27). To determine his estimates of sustainable growth
20 used in the DCF formula, Mr. Bourassa used forecasts of book returns, retention ratios, and growth in
21 the number of common shares from Value Line Investment Survey (Bourassa Dt. at 26).

22 To calculate the EPS growth rate for his DCF models, Mr. Bourassa used forecasts for the
23 proxy companies published by Zack's Investment Research, Standard & Poor's Earnings Guide, and
24 Value Line Investment Survey (Bourassa Rj. at 7). Mr. Bourassa believes that using analysts'
25 forecasts from several reputable sources offsets potentially overly optimistic or overly pessimistic
26 projections from one source. Mr. Bourassa explained that he did not provide an EPS growth rate
27

28 ⁴ These results are from Mr. Bourassa's Rejoinder Testimony, which updated his previous analysis using more recent data. As Mr. Bourassa stated, the results changed very little.

1 projection for Connecticut Water or SJW Corporation, because growth estimates were not available
2 from at least two independent sources. Likewise, he provided no EPS growth rate projection for
3 Middlesex Water in his Rebuttal and Rejoinder Testimony filings, because only one growth rate
4 estimate from an independent source was available, whereas two were available at the time he
5 prepared his Direct Testimony filing (Bourassa Rj. at 7). Mr. Bourassa testified that if he had used
6 the single source published EPS estimates available for Middlesex and Connecticut Water Services, it
7 would have resulted in an increase in the Company's EPS estimate from 8.3 percent to 8.6 percent
8 (Bourassa Rj. at 8).

9 Mr. Bourassa excluded historical DPS and EPS growth rates for the proxy companies from his
10 DCF analysis (Bourassa Rb. at 20). The witness testified that one of the reasons he excluded this
11 historical data is because the indicated cost of equity produced by the DCF model using historical
12 growth rates is less than the current cost of debt, and he is critical of Staff's use of historical DPS and
13 EPS growth rates in its calculations (*Id.*). Mr. Bourassa points out that Value Line's published
14 projected EPS and DPS growth rates for the proxy companies are significantly higher than Staff's
15 computed growth rate, and he believes that Staff's witness chose inputs that "skewed" Staff's results
16 downward (Bourassa Rj. at 12).

17 The Company did not perform a capital asset pricing model ("CAPM") analysis, but criticized
18 Staff's CAPM analysis for its use of median dividend yields and median price appreciation for
19 growth, as opposed to using average dividend yields and price appreciation.

20 The Company disagrees with Staff's position that firm size is a unique, diversifiable risk. The
21 Company believes that risks associated with small size, lack of diversification, limited revenue and
22 cash flow, small customer base, lack of liquidity, regulatory risk, and construction risk are common
23 to small water utilities, and are unique only in the sense that large publicly traded water utilities do
24 not possess the same levels of risk, but states that no market data exist to directly assess how an
25 investor would price those risks (Bourassa Rj. at 14). Utility Source argues that the California Public
26 Utilities Commission, in a 1992 decision, concluded that smaller utilities are more risky than larger
27 ones and required higher equity returns (Bourassa Rb. at 17).
28

1 **b. Staff**

2 In arriving at its cost of equity recommendation, Staff used the constant growth DCF model,
3 the multi-stage DCF model, and the CAPM. Staff arrived at its CAPM estimates using two CAPM
4 models; one using a historical market risk premium, reaching an estimate of 11.0 percent, and one
5 using a current market risk premium, reaching an estimate of 7.8 percent.

6 Staff averaged its DCF results from the constant growth DCF model (7.7 percent) and the
7 multi-stage growth DCF model (9.1 percent), for an average of 8.4 percent, then averaged that with
8 the average of its two CAPM models (9.4 percent), to reach its recommended cost of equity
9 recommendation of 8.9 percent.

10 Staff's witness calculated the growth factor for its constant growth DCF model by averaging
11 historical and projected EPS, DPS, and sustainable growth, giving them equal weight. While Utility
12 Source criticized Staff's use of historical EPS and DPS growth as "unrealistic" because it resulted in
13 indicated costs of equity at or below the cost of debt, Staff responded that its use of historic and
14 forecasted DPS growth is consistent with DCF methodology, uses publicly accessible data which the
15 investment community may consider in forming its growth expectations (Direct Testimony of Steven
16 P. Irvine at 39), and that it would be inappropriate to exclude inputs that produce results that are too
17 low or too high based on a comparison to a chosen benchmark (Irvine Sb. at 10-11). Staff
18 disapproves of Utility Source's sole reliance on analyst's forecasts, because they are known to be
19 overly optimistic and to suggest rates that are too high. Staff is critical of Mr. Bourassa's "solution"
20 to this problem, which was to take his source data from at least two independent sources of analysis,
21 because, Staff argues, using multiple sources of analysts' forecasts only compounds the
22 methodological flaw, rather than providing a remedy for it.

23 Staff estimated the beta for Utility Source to use in its CAPM analysis using the same sample
24 of proxy companies Utility Source used in its DCF analysis. Staff's CAPM formula used current
25 interest rates, and not forecasted interest rates for the timeframe new rates will be in effect, as the
26 Company would prefer, because it is impossible to predict interest rates (Irvine Dt. at 41). Staff
27 believes that present rates are more appropriate than forecasted rates, because analysts do not have
28 any more information about the future than what is already reflected in the current rate, and that the

1 best indicator of tomorrow's yield is today's yield (Irvine Sb. at 9).

2 In response to the Company's criticism that the current market risk premium Staff used in its
3 CAPM analysis is unstable, Staff points out that market risk premium results reflect changes in the
4 market rather than any instability of the methodology itself (*Id.* at 12). Staff states that its CAPM
5 model averages a historical market risk premium with the current market risk premium in order to
6 mitigate the potentiality of market volatility exerting an influence on the market-based CAPM model
7 (Irvine Dt. at 27). Staff defended its use of arithmetic averages in its CAPM analysis, and of median
8 values to derive the dividend yield and growth rate for its DCF method, noting that it uses both
9 arithmetic and geometric means in its analyses because it leads to a more balanced approach, and that
10 while the choice between the two can be confusing, each can be appropriate depending on whether
11 the growth being averaged is historic or prospective (Staff Br. at 6-7; Irvine Sb. at 11).

12 Staff is critical of Utility Source's reliance on a bond risk premium analysis to justify its
13 recommendation for a cost of equity higher than the average of its three DCF analyses. Staff stated
14 that while Utility Source attempted to characterize its bond risk premium analysis as market based
15 because it used market data, it is inherently not a market based approach, as it is susceptible to
16 inappropriate reliance on subjective, judgment-based adjustments. Similarly, Staff argues that the
17 Company's comparable earnings approach for cost of equity estimation is unreasonable, because
18 there are numerous reasons why the returns authorized for the sample utilities in prior rate cases
19 cannot be compared directly to current market expectations, and that actual returns should therefore
20 not be equated with cost of equity (Irvine Sb. at 8-9).

21 **c. Conclusion**

22 The Company's use of the risk premium and comparable earnings methodologies for cost of
23 equity estimation relies extensively on non-market based data and forecasts, and we have consistently
24 rejected their use for that reason. While the Company argues that Staff's cost of equity
25 recommendation is not supported by substantial evidence, we disagree. Staff's cost of equity
26 recommendations were reached using market based financial models that used both historical and
27 forecasted economic information, and which are widely accepted in the financial industry and by
28 state utility commissions. As the Company's witness stated in his direct testimony, the DCF model

requires judgment in selection of appropriate growth rates (Bourassa Dt. at 21). We find that Staff's DCF methodology for estimating Utility Source's cost of equity is balanced, unlike that of the Company, in that it did not exclude inputs that tend to either increase or decrease results, and did not rely exclusively on analysts' growth forecasts, which are known to be overly optimistic. Likewise, we find Staff's CAPM analysis to be a more objective market based approach to cost of equity estimation than Utility Source's comparable earnings approach or its bond risk premium analysis, and therefore more reliable.

Further, we do not find the Company's arguments in favor of a risk premium convincing. We find that premiums for small firm size are inappropriate, because such risk is diversifiable, and premiums should not be provided for risks that an investor may eliminate through diversification.

3. Cost of Capital Summary

For the reasons stated above, we adopt Staff's recommendation for a cost of equity of 8.9 percent:

	<u>Percentage</u>	<u>Cost</u>	<u>Weighted Cost</u>
Long-Term Debt	00.0%	0.0%	0.0%
Common Equity	100%	8.9%	8.9%
Weighted Average Cost of Capital			8.9%

4. Fair Value Rate of Return

As is evident from a review of the record of Decision No. 67446, the background of this case renders it unique. Staff argues that gradualism is an issue in this case because of the across the board increase all the Company's customers are facing. The Company has also acknowledged the existence of the issue of gradualism. In consideration of the unique circumstances of this case, Staff is recommending that its 8.9 percent estimated cost of capital recommendation be applied, unadjusted, as the FVROR to the Company's FVRB for its sewer division, but that it be adjusted downward for the FVROR to be applied to the Company's water division FVRB. Staff states that if its 8.9 percent estimated cost of capital were to be applied, unadjusted, to the water division FVRB, the resulting rate increase would be precipitous, approaching the level of rate increase that we rejected in Decision No. 67446 as being unconscionable. In the case leading to that Decision, Staff had recommended that initial rates be set at a level approximately 189 percent over the unauthorized rates set by, and

1 being charged by, the homeowners' association, and we found such a level of increase to be
2 unreasonable. Staff recommends a FVROR for the water division of 6.23 percent, and for the sewer
3 division of 8.9 percent. Staff believes its FVROR recommendation in this case is appropriate when
4 all relevant factors are considered, including the history of unauthorized rates, the inclusion of plant
5 not used and useful during the test year in rate base, the concept of gradualism, and the "hybrid"
6 nature of this case because it stems from Decision No. 67446, which granted a CC&N, but ordered a
7 rate case to be filed prior to the typical five-year period normally ordered when a CC&N is granted
8 (Staff Br. at 16, 17). Staff contends that adoption of its FVROR recommendation will not prevent the
9 Company from receiving a just and reasonable return on FVRB (*Id.*). Staff states that if its FVROR
10 recommendations are adopted, the revenue increases for the water division and the sewer division
11 will be at approximately the same level, at 110 percent and 106.71 percent, respectively.

12 Under the alternative Scenario Two that Staff presented, which includes the same FVRB and
13 pro forma revenues as Staff's recommended Scenario One, and which applies a rate of return of 8.9
14 percent, the revenue increase for the water division would be 153.29 percent. Under Staff's
15 alternative Scenario Three, which excludes Deep Well Number Four and the pro forma revenues, and
16 which applies rate of return of 8.90 percent, the revenue increase for the water division would be
17 286.63 percent.

18 Utility Source is opposed to Staff's recommended FVROR for the water division, and argues
19 that the fact that Staff made a computation to arrive at its recommendation renders it "inappropriate,"
20 "illegal," inconsistent with the *Simms* standard,⁵ and in violation of Arizona law (Company Br. at 8-
21 12).

22 The Company further argues that the 6.23 percent and 8.9 percent FVRORs recommended by
23 Staff are "illegal and unreasonable," because Staff did not test their reasonableness against the market
24 price for Baa bonds or the prime rate, and because they do not immediately provide the Company
25 with a positive operating margin (Company Br. at 12-13). Utility Source also disagrees with Staff's
26 characterization of this case as a "hybrid" between a CC&N application and a rate application.

27
28 ⁵ *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 151, 294 P.2d 378, 382 (1956).

1 Mr. Hitesman contends in his post-hearing brief that the rate increases proposed by both the
2 Company and Staff are not reasonable from the customers' perspective, and he questioned whether
3 evidence was presented regarding the Company's legal obligation to provide service to its customers
4 at reasonable rates. Mr. Hitesman believes that the proposed rate increases will have an
5 unreasonable, severe impact on Utility Source's customers, who he believes live in a low income
6 community and are also bearing unreasonably high real estate costs. Mr. Hitesman believes that
7 Utility Source's customers assumed, when they moved into the development served by the Company,
8 either 1) that rates would either remain the same as those currently in effect, or 2) would be the rates
9 specified in the Declaration of Covenants, Conditions and Restrictions for Flagstaff Meadows
10 Property Owner's Association ("CC&Rs"), both of which are lower than the increases requested by
11 the Company or proposed by Staff. Mr. Hitesman argues that the proposed rates are higher than
12 those charged by the City of Flagstaff, higher than average rates in Coconino County, and higher than
13 average rates in the State of Arizona. Mr. Hitesman believes that Utility Source has a high-producing
14 group of wells, and that the Company's water capacity provides assurance of the Company's long-
15 term sustainability. Mr. Hitesman states that there is no question that a profitable utility is crucial for
16 his community, but requests that the Commission balance the ratepayers' interests with ensuring the
17 profitability of the Company.

18 The Commission has discretion to consider all relevant and necessary factors in the exercise
19 of our constitutional rate setting authority, to ensure that the rates charged by utilities under our
20 jurisdiction are just and reasonable for both utility companies and their ratepayers. Like Mr.
21 Hitesman, we have been concerned, and remain concerned, with the impact on ratepayers of the
22 required increase in rates from the unauthorized, artificially low levels charged by the developer of
23 Flagstaff Meadows, to the level necessary to allow Utility Source to provide adequate service. Due
24 to our concern over the impact on ratepayers of the size of a rate increase that reflected the projected
25 cost of service over a five year timeframe, we did not authorize a rate increase in Decision No.
26 67446. Instead, we ordered the Company to file a rate case sooner than would otherwise be required,
27 in order to give us the ability to examine actual operating information as opposed to projections. We
28 were also concerned that customers have adequate notice of a possible increase in rates. For that

1 reason we ordered the Company, in Decision No. 67446, to provide notice to its customers that the
2 rates resulting from the ordered rate case filing would likely be higher than the rates we authorized in
3 Decision No. 67446.

4 Staff is correct in its argument that making appropriate adjustments to the rate of return
5 applied to the FVRB is an appropriate means of setting just and reasonable rates, even if such
6 adjustments may fall outside the parameters of a strict cost of capital analysis (*See* Staff Br. at 16-17).
7 We have accepted the Company's proposal to include plant in rate base that was not used and useful
8 during the test year, which directly reduces risk to the Company, and is properly reflected as an
9 adjustment to the FVROR for the water division. According to Staff, Staff's recommended FVROR
10 of 6.23 percent for the water division, and 8.9 percent for the sewer division, when applied to the
11 FVRB, will provide the Company with an operating margin of 47 percent for the water division and
12 41 percent for the sewer division, when the pro forma revenues proposed by the Company and
13 adopted herein are included (Surrebuttal Testimony of Jeffrey M. Michlik, Exh. S-2 at 10). While the
14 Company protested that its proposal to include pro forma revenues should not be considered when
15 discussing estimated operating margins, we disagree, because the Company's proposal was made as
16 part of an overall proposal to include Deep Well Number Four, which will be necessary to serve the
17 new customers, in rate base at this time. While the Company disagrees with Staff's characterization
18 of this case as a "hybrid" between a CC&N application and a rate application, we find that
19 characterization to be particularly apt, because we declined to set the Company's rates in the CC&N
20 application proceeding based on five year projections, but ordered the Company to file the instant
21 rate application instead. In addition, with Staff's FVROR recommendation applied to FVRB, the
22 Company will be in approximately the same position it would have been had it obtained its CC&N in
23 the normal and proper legal and procedural manner, in which new companies are not expected to
24 immediately have positive operating margins (*See* Staff Br. at 19, referencing figures in the Rejoinder
25 Testimony of Thomas J. Bourassa, Exh. A-5, Attached Rejoinder Exhibit 1 at pages 3 and 7).
26 Considering all the unique facts associated with this case and the CC&N proceeding, we find that the
27 FVROR recommendation of Staff is just and reasonable under the unique circumstances of this case,
28 and we will therefore adopt it.

G. AUTHORIZED INCREASE

Based on our findings herein, we determine that Utility Source is entitled to a gross revenue increase of \$192,688 for its water division.

FVRB	\$2,753,095
Adjusted Operating Income	(21,340)
Required FVROR	6.23%
Required Operating Income	171,518
Operating Income Deficiency	192,858
Gross Revenue Conversion Factor	<u>1.0000</u>
Gross Revenue Increase	\$192,858

Based on our findings herein, we determine that Utility Source is entitled to a gross revenue increase of \$121,549 for its sewer division.

FVRB	\$1,113,582
Adjusted Operating Income	(22,441)
Required FVROR	8.90%
Required Operating Income	99,109
Operating Income Deficiency	121,549
Gross Revenue Conversion Factor	<u>1.0000</u>
Gross Revenue Increase	\$121,549

H. RATE DESIGN

Both the Company and Staff propose using an inverted tier rate design for residential water division customers. The Company's rate design also includes an inverted rate design for irrigation customers.

Staff is critical of the breakpoint for the first block in the Company's proposed water rate design, stating that it can have the effect of delaying the point at which a customer will experience increasing rate impact from increased usage, thereby obscuring the price signal that an inverted rate design is intended to send (Tr. at 140). Staff also opposes the Company's proposal to switch to an inverted tier rate design for irrigation customers (Surrebuttal Testimony of Jeffrey M. Michlik, Exh. S-2 at 13). The Company did not address rate design issues on brief. Staff's proposed rate design is reasonable and will be adopted.

* * * * *

Having considered the entire record herein and being fully advised in the premises, the Commission finds, concludes, and orders that:

FINDINGS OF FACT

1
2 1. Utility Source is an Arizona public service corporation providing water and sewer
3 service to an area located approximately eight miles west of Flagstaff, near Bellemont, in Coconino
4 County, Arizona pursuant to authority granted by the Commission in Decision No. 67446 (January 4,
5 2005).

6 2. At the end of the test year, Utility Source provided service to approximately 337 water
7 and sewer customers.

8 3. On May 1, 2006, Utility Source filed an application for a determination of the current
9 fair value of its utility plant and property and for increases in its rates and charges for water and
10 wastewater utility service provided to customers in the Company's service area in Coconino County,
11 Arizona.

12 4. On May 31, 2006, Staff filed a letter stating that the Company's application had not
13 met the sufficiency requirements pursuant to A.A.C. R14-2-103.

14 5. On June 16, 2006, Utility Source filed additional information in response to Staff's
15 deficiency letter.

16 6. On July 3, 2006, Staff filed a letter indicating that the Company's application had met
17 the sufficiency requirements, and classifying the Company as a Class C utility.

18 7. By Procedural Order issued July 10, 2006, a hearing in this matter was scheduled for
19 January 22, 2007, and other procedural deadlines were established.

20 8. On August 16, 2006, the Company filed an Affidavit of Mailing, and on August 25,
21 2006, filed an Affidavit of Publication.

22 9. Public comments in opposition to the rate increase were filed on August 25, 2006,
23 September 20, 2006, September 26, 2006, September 28, 2006, October 2, 2006, October 6, 2006,
24 October 13, 2006 (five separate comments), October 20, 2006, October 24, 2006, October 27, 2006,
25 November 21, 2006, February 2, 2007, April 6, 2007 (four separate comments), and April 27, 2007.

26 10. On September 26, 2006, the Ponderosa Fire District filed a Motion to Intervene as a
27 customer of the Company. No opposition to the request was received, and the Motion to Intervene
28 was granted by Procedural Order issued November 8, 2006.

1 11. On October 25, 2006, Staff filed a Motion to Extend Filing Deadline and Schedule
2 Procedural Conference, stating that Staff had not received adequate information from the Company
3 regarding plant in service and that data responses from the Company had taken longer than the time
4 allowed. Staff requested that the deadline for filing of its Direct Testimony be extended by 60 days,
5 and that a procedural conference be scheduled to discuss adjustment of other filing deadlines and
6 other procedural matters.

7 12. On November 8, 2006, a Procedural Order was issued scheduling a procedural
8 conference for November 28, 2006.

9 13. On November 14, 2006, Mr. David Hitesman and Mr. Dennis Jones filed a Motion to
10 Intervene. The Motion to Intervene included a request that the Commission hold a hearing in the
11 Coconino County Board of Supervisors Meeting Room. Attached to the Motion to Intervene was a
12 petition signed by over 100 customers of the Company requesting that a hearing be held in
13 Bellemont, Arizona, where the Company is located. The petition also included a request that the
14 Commission consider postponing the proposed rate increase until an additional 260 homes planned to
15 connect to the Utility Source system are completed.

16 14. On November 28, 2006, the Procedural Conference was convened as scheduled. The
17 parties were directed to confer and recommend a procedural schedule.

18 15. On November 30, 2006, Staff filed a Notice of Filing Recommended Schedule
19 Changes.

20 16. On December 19, 2006, the Ponderosa Fire District submitted its Commentary &
21 Exhibits of Intervention in Response to the Proposed Rate Increases by Utility Source LLC.

22 17. On December 20, 2006, a Procedural Order was issued granting the Motion to
23 intervene by David Hitesman and Dennis Jones. The Procedural Order also continued the hearing
24 date to April 3, 2007, continued related procedural deadlines, and extended the applicable timeclock
25 in this case by 75 days.

26 18. On January 10, 2007, Staff filed a Motion for Extension of Deadline requesting
27 additional time to file its Direct Testimony. On January 12, 2007, the Company filed its Response to
28 Staff's Motion, stating that it did not object to the time extension, provided other deadlines remained

1 unchanged.

2 19. On January 16, 2007, intervenors David Hitesman and Dennis Jones filed a document
3 titled Evidence for Docket No. WS-04235A-06-0303. Therein, the intervenors state that the rate
4 increase proposed by the Company is unreasonable and should therefore not be approved, pursuant to
5 A.R.S. § 40-361.A. Intervenors state that the community's CC&Rs provide for water and
6 wastewater use assessments for each lot for which a building permit for a residence has been issued,
7 and that it is reasonable for residents to assume that their utility bills would be bound by the terms of
8 the CC&Rs; that the proposed rate increase is a 197 percent increase over current rates and 142
9 percent over rates dictated by the CC&Rs; that the increase constitutes 2.8-3.2 percent of the Average
10 Household Income for Coconino County; that although the Company currently serves 326 residential
11 customers, plans are underway to increase the customer base by 274 residential customers, reducing
12 the need for a significant rate increase; that the proposed rates are greater than average water and
13 wastewater rates for the City of Flagstaff, Coconino County, and the State of Arizona; and that the
14 City of Flagstaff's well capacity is approximately 1,263 gallons per day ("gpd") for 15,300 residential
15 customers, compared with the Company's 67 percent higher well capacity of approximately 2,111
16 gpd for 326 residential customers.

17 20. On January 19, 2007, Staff filed the Direct Testimony of Jeffrey M. Michlik, Steven P.
18 Irvine, and Jian W. Liu.

19 21. On January 22, 2007, the date originally noticed as the date of the hearing in this
20 matter, the hearing was convened for the purpose of taking public comment. Counsel for the
21 Company and Staff appeared. No members of the public appeared to provide public comment.

22 22. On January 25, 2007, a Procedural Order was issued setting a public comment session
23 at the Coconino County Board of Supervisors Meeting Room in Flagstaff, Arizona, for March 19,
24 2007 at 5:00 p.m.

25 23. On February 16, 2007, the Company filed the Rebuttal Testimony of Thomas J.
26 Bourassa.

27 24. On March 5, 2007, Staff filed a Motion for Extension and Request for Scheduling
28 Conference in order to address issues raised by a change in the Company's position in this case.

1 25. On March 13, 2007, Staff filed a Notice of Filing Recommended Schedule Changes,
2 recommending that the hearing be moved to May 1, 2007, and that other procedural deadlines be
3 moved accordingly.

4 26. On March 16, 2007, a Procedural Order was issued continuing the hearing in this
5 matter to May 1, 2007, and continuing other procedural deadlines accordingly.

6 27. On March 19, 2007, Staff filed the Surrebuttal Testimony of Jeffrey M. Michlik and
7 Steven P. Irvine.

8 28. On March 19, 2007, a Special Open Meeting of the Commission was convened in the
9 Coconino County Board of Supervisors Meeting Room in Flagstaff, Arizona, for the purpose of
10 taking public comment on the Company's application. Numerous members of the public appeared,
11 and eighteen customers spoke in order to provide their comments for the record in this proceeding.

12 29. On March 20, 2007, the Ponderosa Fire District filed its Exhibits in Response to the
13 Proposed Rate Increases Submitted by Utility Source LLC Rebuttal and Arizona Corporation
14 Commission Testimony. Therein the District stated that "[s]ince the existing customers may possibly
15 have already paid part or all of the development costs of the utility system, any to date revenue
16 deficits should be considered as part of the overall development cost because the rates were
17 knowingly set abnormally low as an enticement for homebuyers."

18 30. On March 21, 2007, Staff filed Revised Surrebuttal Testimony to reflect corrected
19 schedule information.

20 31. On March 27, 2007, comments labeled with the heading "NOTE: The Commission
21 received this document from intervenor Dennis Jones at the public comment session conducted in
22 Flagstaff, AZ, on March 19, 2007, in Docket No. WS-04235A-06-0303" were filed in the docket.

23 32. On April 2, 2007, the Company filed the Rejoinder Testimony of Thomas J. Bourassa.

24 33. On April 6, 2007, the Company filed the Supplemental Rejoinder Testimony of
25 Lonnie McLeve regarding the customer comments at the March 19, 2007 Public Comment Meeting
26 held in Flagstaff, Arizona.

27 34. On April 11, 2007, Staff submitted revised schedules in response to the Rejoinder
28 Testimony of Thomas J. Bourassa filed on April 2, 2007.

35. On April 13, 2007, the Pre-Hearing Conference was convened as scheduled. Counsel for the Company and Staff appeared.

36. On April 18, 2007, a Procedural Order was issued continuing the hearing to May 2, 2007.

37. On April 27, 2007, the Company filed a Motion for Continuance due to unavailability of counsel.

38. On April 30, 2007, a Procedural Order was issued continuing the hearing to June 19, 2007, and suspending the applicable timeclock during the continuance.

39. The hearing commenced as scheduled on June 19, 2007, before a duly authorized Administrative Law Judge of the Commission. The Company and Staff appeared through counsel and presented evidence. Intervenors Mr. Starr Lamphere, Mr. David Hitesman, and Mr. Dennis Jones appeared, each on his own behalf.

40. On June 22, 2007, Staff filed schedules that were requested by the Administrative Law Judge during the hearing.

41. On June 29, 2007, the Company filed Comments On and Objections to Late-Filed ALJ Scenario Number 4.

42. On July 10, 2007, the Company made a filing documenting compliance with Decision No. 67446. This filing addressed an issue raised at the hearing regarding ownership of wellsite property.

43. Closing Briefs were filed by the Company, Mr. Hitesman and Staff, and the matter was taken under advisement.

44. Current rates, the rates proposed by the Company, and the rates proposed by Staff for the water division are as follows:

	Present Rates	Proposed Company	Rates Staff
<u>MONTHLY USAGE CHARGE:</u>			
5/8" x 3/4" Meter	\$ -	\$35.74	\$18.50
3/4" Meter	\$6.48	35.74	18.50
1" Meter	8.02	89.34	46.50

1	1 ½" Meter	9.62	178.69	92.50
	2" Meter	14.00	285.90	148.00
2	3" Meter	-	571.80	296.00
	4" Meter	58.00	893.43	462.50
3	6" Meter	89.80	1,786.86	925.00

COMMODITY RATES

5/8" x ¾" Meter (Residential & Commercial)

Gallons Included in Minimum 0 0 0

Excess of Minimum – per 1,000 Gallons:

From 1 to 6,000 Gallons N/A N/A N/A

From 6,001 to 15,000 Gallons N/A N/A N/A

In excess of 15,000 Gallons N/A N/A N/A

From 1 to 4,000 Gallons N/A \$9.60 N/A

From 4,001 to 12,000 Gallons N/A 12.48 N/A

Over 12,000 Gallons N/A 16.22 N/A

From Zero to 4,000 Gallons N/A N/A \$4.80

From 4,001 to 9,000 Gallons N/A N/A 7.16

Over 9,000 Gallons N/A N/A 8.60

¾" Meter (Residential & Commercial)

Gallons Included in Minimum 0 0 0

Excess of Minimum – per 1,000 Gallons:

From 1 to 6,000 Gallons \$2.83 N/A N/A

From 6,001 to 15,000 Gallons 3.32 N/A N/A

In excess of 15,000 Gallons 4.71 N/A N/A

From 1 to 4,000 Gallons N/A \$9.60 N/A

From 4,001 to 12,000 Gallons N/A 12.48 N/A

Over 12,000 Gallons N/A 16.22 N/A

From Zero to 4,000 Gallons N/A N/A \$4.80

From 4,001 to 9,000 Gallons N/A N/A 7.16

Over 9,000 Gallons N/A N/A 8.60

1" Meter (Residential & Commercial)

Gallons Included in Minimum 0 0 0

Excess of Minimum – per 1,000 Gallons:

From 1 to 6,000 Gallons \$2.83 N/A N/A

From 6,001 to 15,000 Gallons 3.32 N/A N/A

In excess of 15,000 Gallons 4.71 N/A N/A

From 1 to 30,000 Gallons N/A \$12.48 N/A

Over 30,000 Gallons N/A 16.22 N/A

From Zero to 27,000 Gallons N/A N/A \$7.16

Over 27,000 Gallons N/A N/A 8.60

1 ½" Meter (Residential & Commercial)

Gallons Included in Minimum 0 0 0

Excess of Minimum – per 1,000 Gallons:

From 1 to 6,000 Gallons N/A N/A N/A

1	From 6,001 to 15,000 Gallons	N/A	N/A	N/A
	In excess of 15,000 Gallons	N/A	N/A	N/A
2	From 1 to 60,000 Gallons	N/A	\$12.48	N/A
	Over 60,000 Gallons	N/A	16.22	N/A
3	From Zero to 57,000 Gallons	N/A	N/A	\$7.16
4	Over 57,000 Gallons	N/A	N/A	8.60
5	2" Meter (Residential & Commercial)			
	Gallons Included in Minimum	0	0	0
6	<u>Excess of Minimum – per 1,000 Gallons:</u>			
	From 1 to 6,000 Gallons	N/A	N/A	N/A
7	From 6,001 to 15,000 Gallons	N/A	N/A	N/A
	In excess of 15,000 Gallons	N/A	N/A	N/A
8	From 1 to 96,000 Gallons	N/A	\$12.48	N/A
9	Over 96,000 Gallons	N/A	16.22	N/A
	From Zero to 94,000 Gallons	N/A	N/A	\$7.16
10	Over 94,000 Gallons	N/A	N/A	8.60
11	3" Meter (Residential & Commercial)			
	Gallons Included in Minimum	0	0	0
12	<u>Excess of Minimum – per 1,000 Gallons:</u>			
13	From 1 to 6,000 Gallons	N/A	N/A	N/A
	From 6,001 to 15,000 Gallons	N/A	N/A	N/A
14	In excess of 15,000 Gallons	N/A	N/A	N/A
	From 1 to 192,000 Gallons	N/A	\$12.48	N/A
15	Over 192,000 Gallons	N/A	16.22	N/A
	From Zero to 195,000 Gallons	N/A	N/A	\$7.16
16	Over 195,000 Gallons	N/A	N/A	8.60
17	4" Meter (Residential & Commercial)			
	Gallons Included in Minimum	0	0	0
18	<u>Excess of Minimum – per 1,000 Gallons:</u>			
19	From 1 to 6,000 Gallons	N/A	N/A	N/A
	From 6,001 to 15,000 Gallons	N/A	N/A	N/A
20	In excess of 15,000 Gallons	N/A	N/A	N/A
21	From 1 to 300,000 Gallons	N/A	\$12.48	N/A
	Over 300,000 Gallons	N/A	16.22	N/A
22	From Zero to 309,000 Gallons	N/A	N/A	\$7.16
23	Over 309,000 Gallons	N/A	N/A	8.60
24	6" Meter (Residential & Commercial)			
	Gallons Included in Minimum	0	0	0
25	<u>Excess of Minimum – per 1,000 Gallons:</u>			
	From 1 to 6,000 Gallons	N/A	N/A	N/A
26	From 6,001 to 15,000 Gallons	N/A	N/A	N/A
	In excess of 15,000 Gallons	N/A	N/A	N/A
27	From 1 to 600,000 Gallons	N/A	\$12.48	N/A
28	Over 600,000 Gallons	N/A	16.22	N/A

From Zero to 615,000 Gallons	N/A	N/A	\$7.16
Over 615,000 Gallons	N/A	N/A	8.60

Multi-Family Mobile home and Commercial Customers

All consumption per 1,000 gallons:	\$2.97	\$9.26	N/A
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Irrigation Meters

Charge per 1,000 gallons for usage:	†	N/A	\$9.26
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Standpipe or Bulk Water

Charge per 1,000 gallons for usage:	\$6.00	\$10.35	\$10.35
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Construction Water

Charge per 1,000 gallons for usage:	\$6.00	\$10.35	\$10.35
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SERVICE LINE AND METER INSTALLATION CHARGES:

(Refundable pursuant to A.A.C. R14-2-405)

5/8" x 3/4" Meter	-	-	\$520.00
3/4" Meter	\$575.00	\$575.00	575.00
1" Meter	660.00	660.00	660.00
1 1/2" Meter	900.00	900.00	900.00
2" Turbine Meter	1,525.00	1,525.00	1,525.00
2" Compound Meter	-	-	2,320.00
3" Turbine Meter	-	-	2,275.00
3" Compound Meter	-	-	3,110.00
4" Turbine Meter	3,360.00	3,360.00	3,360.00
4" Compound Meter	-	-	4,475.00
6" Turbine Meter	6,035.00	6,035.00	6,035.00
6" Compound Meter	-	-	8,050.00

SERVICE CHARGES:

Establishment of Service	\$20.00	\$20.00	\$20.00
Establishment of Service (After Hours)	40.00	40.00	40.00
Re-establishment of Service	*	*	*
Reconnection of Service	50.00	50.00	50.00
Reconnection (Delinquent and After Hours)	40.00	40.00	40.00
Charge for moving meter	Cost	Cost	Cost
After hours service charge	40.00	40.00	40.00
Minimum Deposit Requirement	**	**	**
Deposit Interest	3.00%	3.00%	Per Rule
Meter Test	20.00	20.00	20.00
Meter Re-Read	10.00	10.00	10.00
Charge for NSF Check	20.00	20.00	20.00
Late Payment charge for delinquent bill	1.50%	1.50%	***

Deferred Payment Finance Charge	1.50%	1.50%	***
Main Extension & Additional Facility Agreements	***	***	***

† The Company proposes that irrigation customers be charged Commodity Charges in the same manner as Residential and Commercial customers.

* Per Commission rule A.A.C. R-142-403(D).

** Per Commission rule A.A.C. R14-2-403(B).

*** Per Commission rule A.A.C. R14-2-406(B).

45. Current rates, the rates proposed by the Company, and the rates proposed by Staff for the sewer division are as follows:

	Present Rates	Proposed Company	Rates Staff
<u>MONTHLY CHARGES:</u>			
Rate per 1,000 gal. water usage:			
Residential	\$2.73	\$6.86	\$5.84
Car washes, Laundromats, commercial, manufacturing	2.67	6.70	5.71
Hotel and Motels	3.58	8.99	7.66
Restaurants	4.42	11.09	9.46
Industrial Laundries	3.92	9.84	8.39
Waste Haulers	80.00	200.80	171.20
Restaurant Grease	70.00	175.70	149.80
Treatment Plant Sludge	80.00	200.80	171.20
Mud Sump Waste	250.00	627.50	535.00
<u>SERVICE CHARGES:</u>			
Establishment of Service	\$20.00	\$20.00	\$20.00
Establishment of Service (After Hours)	40.00	40.00	40.00
Re-establishment of Service	*	*	*
Reconnection of Service	50.00	50.00	50.00
Reconnection (Delinquent and After Hours)	40.00	40.00	40.00
Minimum Deposit Requirement	**	**	**
Deposit Interest	3.00%	3.00%	Per Rule
Charges for NSF Check	20.00	20.00	20.00
Deferred Payment Finance Charge	1.50%	1.50%	***
Late Payment, Per Month	***	***	***
Service Calls, per hour (After Hours only)	40.00	40.00	40.00
Service Lateral Connection Charges:			
Residential	500.00	500.00	500.00
Commercial	Cost	Cost	Cost
Main Extension Tariff	Cost	Cost	Cost

* Per Commission rule A.A.C. R-142-603(D).

** Per Commission rule A.A.C. R14-2-603(B).

*** Per Commission rule A.A.C. R14-2-608(F).

1 46. According to the Company's application, in the test year ended December 31, 2005,
2 Utility Source's water division had adjusted operating income of (\$23,286) on an adjusted OCRB of
3 \$2,753,096, for a (-0.85) percent rate of return.
4

5 47. For its water division, Utility Source requests a revenue increase of \$312,361, and
6 Staff recommends a revenue increase of \$192,858.

7 48. For purposes of this proceeding, we determine that Utility Source's water division has
8 an OCRB and a FVRB of \$2,753,095.

9 49. The increase proposed by Utility Source for its water division would produce an
10 excessive return on FVRB.

11 50. For Utility Source's water division, a FVROR on FVRB of 6.23 percent is reasonable
12 and appropriate, for the reasons discussed herein.
13

14 51. For its water division, Utility Source is entitled to a gross revenue increase of
15 \$192,858.

16 52. The rates set herein for the Company's water division produce an increase in annual
17 revenues for the water division of 110.63 percent which results in a monthly increase of \$23.10, from
18 \$19.89 to \$42.99, or 116.14 percent, for the average usage (4,740 gallons/month) 3/4-inch meter
19 water customer, and a monthly increase of \$22.07, from \$19.22 to \$41.29, or 114.83 percent, for the
20 median usage (4,500 gallons/month) 3/4-inch meter water customer.
21

22 53. According to the Company's application, in the test year ended December 31, 2005,
23 Utility Source's sewer division had adjusted operating income of (\$22,959) on an adjusted OCRB of
24 \$1,111,382, for a (-2.07) percent rate of return.

25 54. For its sewer division, Utility Source requests a revenue increase of \$139,654, and
26 Staff recommends a revenue increase of \$121,549.
27
28

1 55. For purposes of this proceeding, we determine that Utility Source's sewer division has
2 an OCRB and FVRB of \$1,113,582.

3 56. The increase proposed by Utility Source for its sewer division would produce an
4 excessive return on FVRB.

5 57. For Utility Source's sewer division, a FVROR on FVRB 8.90 percent is reasonable
6 and appropriate.

7 58. For its sewer division, Utility Source is entitled to a gross revenue increase of
8 \$121,549.

9 59. The rates set herein for the Company's sewer division produce an increase in annual
10 revenues for the sewer division of 106.71 percent which results in a monthly increase of \$14.75, from
11 \$12.94 to \$27.69, or 114.00 percent, for the average usage (4,740 gallons/month) 3/4-inch meter
12 sewer customer, and a monthly increase of \$14.00, from \$12.29 to \$26.29, or 114.00 percent, for the
13 median usage (4,500 gallons/month) 3/4-inch meter sewer customer.

14 60. Utility Source is not located within any Active Management Area, and consequently is
15 not subject to Arizona Department of Water Resources ("ADWR") reporting and conservation rules.

16 61. Based on data submitted by the Company, the Arizona Department of Environmental
17 Quality ("ADEQ") has determined that the Company's water system (PWS #03-300) has no
18 deficiencies and is delivering water that meets the water quality standards required by the Arizona
19 Administrative Code.

20 62. A letter from ADEQ dated March 21, 2006, indicates that the Company's wastewater
21 system is in compliance with ADEQ regulations.

22 63. The U.S. Environmental Protection Agency ("EPA") has reduced the arsenic
23 maximum contaminant level ("MCL") in drinking water from 50 parts per billion ("ppb") to 10 ppb.
24 The most recent arsenic levels at Utility Source did not exceed 10 ppb for both shallow wells
25
26
27
28

1 (blending all five shallow wells at main before tank) and the four deep wells. Based on this arsenic
2 concentration, the Company is in compliance with the new arsenic MCL.

3 64. Utility Source has no outstanding Commission compliance issues.

4 65. Staff's recommendation that the Company use the depreciation rates appearing in
5 Tables E1 and E2 of Exhibit JWL (Exh. S-1, Direct Testimony of Jian W. Liu, Exh. JWL at 8-9) is
6 reasonable and should be adopted.

7
8 66. Because an allowance for the property tax expense of the Company is included in the
9 Company's rates and will be collected from its customers, the Commission seeks assurances from the
10 Company that any taxes collected from ratepayers have been remitted to the appropriate taxing
11 authority. It has come to the Commission's attention that a number of water companies have been
12 unwilling or unable to fulfill their obligation to pay the taxes that were collected from ratepayers,
13 some for as many as twenty years. It is reasonable, therefore, that as a preventive measure Utility
14 Source annually file, as part of its annual report, an affidavit with the Utilities Division attesting that
15 the Company is current in paying its property taxes in Arizona.
16

17 CONCLUSIONS OF LAW

18 1. Utility Source LLC is a public service corporation within the meaning of Article XV
19 of the Arizona Constitution and A.R.S. Sections 40-250 and 40-241.

20 2. The Commission has jurisdiction over the Company and the subject matter of the
21 application.

22 3. Notice of the application was provided in the manner prescribed by law.

23 4. The fair value of Utility Source LLC's water division rate base is \$2,753,095, and
24 applying a 6.23 percent fair value rate of return on this fair value rate base produces rates and charges
25 that are just and reasonable.

26 5. The fair value of Utility Source LLC's sewer division rate base is \$1,113,582, and
27 applying an 8.90 percent fair value rate of return on this fair value rate base produces rates and
28

1 charges that are just and reasonable.

2 6. The rates and charges established herein are just and reasonable and in the public
3 interest.

4 **ORDER**

5 IT IS THEREFORE ORDERED that Utility Source, LLC is hereby authorized and directed to
6 file with the Commission, on or before January 31, 2008, the following schedules of revised rates and
7 charges, which shall be effective for all service rendered on and after February 1, 2008:

8 **WATER DIVISION**

9 **MONTHLY USAGE CHARGE**

10

11	5/8" x 3/4" Meter	\$18.50
12	3/4" Meter	18.50
13	1" Meter	46.50
14	1 1/2" Meter	92.50
15	2" Meter	148.00
	3" Meter	296.00
	4" Meter	462.50
	6" Meter	925.00

16 **COMMODITY RATES**

17 5/8" x 3/4" Meter (Residential & Commercial)

18 Gallonage Charge per 1,000 Gallons

19

From Zero to 4,000 Gallons	\$4.80
From 4,001 to 9,000 Gallons	7.16
Over 9,000 Gallons	8.60

20 3/4" Meter (Residential & Commercial)

21 Gallonage Charge per 1,000 Gallons

22

From Zero to 4,000 Gallons	\$4.80
From 4,001 to 9,000 Gallons	7.16
Over 9,000 Gallons	8.60

23 1" Meter (Residential & Commercial)

24 Gallonage Charge per 1,000 Gallons

25

From Zero to 27,000 Gallons	\$7.16
Over 27,000 Gallons	8.60

26 1 1/2" Meter (Residential & Commercial)

27 Gallonage Charge per 1,000 Gallons

28

From Zero to 57,000 Gallons	\$7.16
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1	Over 57,000 Gallons	8.60
2	2" Meter (Residential & Commercial)	
3	Gallage Charge per 1,000 Gallons	
4	From Zero to 94,000 Gallons	\$7.16
5	Over 94,000 Gallons	8.60
6	3" Meter (Residential & Commercial)	
7	Gallage Charge per 1,000 Gallons	
8	From Zero to 195,000 Gallons	\$7.16
9	Over 195,000 Gallons	8.60
10	4" Meter (Residential & Commercial)	
11	Gallage Charge per 1,000 Gallons	
12	From Zero to 309,000 Gallons	\$7.16
13	Over 309,000 Gallons	8.60
14	6" Meter (Residential & Commercial)	
15	Gallage Charge per 1,000 Gallons	
16	From Zero to 615,000 Gallons	\$7.16
17	Over 615,000 Gallons	8.60
18	<u>Multi-Family Mobile home and Commercial</u>	
19	<u>Customers</u>	
20	All consumption per 1,000 gallons:	N/A
21	<u>Irrigation Meters</u>	
22	Charge per 1,000 gallons for usage:	\$9.26
23	<u>Standpipe or Bulk Water</u>	
24	Charge per 1,000 gallons for usage:	\$10.35
25	<u>Construction Water</u>	
26	Charge per 1,000 gallons for usage:	\$10.35
27	5/8" x 3/4" Meter	\$520.00
28	3/4" Meter	575.00
29	1" Meter	660.00
30	1 1/2" Meter	900.00
31	2" Turbine Meter	1,525.00
32	2" Compound Meter	2,320.00
33	3" Turbine Meter	2,275.00
34	3" Compound Meter	3,110.00
35	4" Turbine Meter	3,360.00
36	4" Compound Meter	4,475.00
37	6" Turbine Meter	6,035.00
38	6" Compound Meter	8,050.00

SERVICE CHARGES

Establishment of Service	\$20.00
Establishment of Service (After Hours)	40.00
Re-establishment of Service	*
Reconnection of Service	50.00
Reconnection (Delinquent and After Hours)	40.00
Charge for moving meter	Cost
After hours service charge	40.00
Minimum Deposit Requirement	**
Deposit Interest	Per Rule
Meter Test	20.00
Meter Re-Read	10.00
Charge for NSF Check	20.00
Late Payment charge for delinquent bill	***
Deferred Payment Finance Charge	***
Main Extension & Additional Facility Agreements	***

- * Per Commission rule A.A.C. R-142-403(D).
 ** Per Commission rule A.A.C. R14-2-403(B).
 *** Per Commission rule A.A.C. R14-2-406(B).

SEWER DIVISON**MONTHLY CHARGES**

Rate per 1,000 gal. water usage:	
Residential	\$5.84
Car washes, Laundromats, commercial, manufacturing	5.71
Hotel and Motels	7.66
Restaurants	9.46
Industrial Laundries	8.39
Waste Haulers	171.20
Restaurant Grease	149.80
Treatment Plant Sludge	171.20
Mud Sump Waste	535.00

SERVICE CHARGES

Establishment of Service	\$20.00
Establishment of Service (After Hours)	40.00
Re-establishment of Service	*
Reconnection of Service	50.00
Reconnection (Delinquent and After Hours)	40.00
Minimum Deposit Requirement	**

1	Deposit Interest	Per Rule
	Charges for NSF Check	20.00
2	Deferred Payment Finance Charge	***
	Late Payment, Per Month	***
3	Service Calls, per hour (After Hours only)	40.00
	Service Lateral Connection Charges:	
4	Residential	500.00
5	Commercial	Cost
	Main Extension Tariff	Cost

6 * Per Commission rule A.A.C. R-142-603(D).

7 ** Per Commission rule A.A.C. R14-2-603(B).

8 *** Per Commission rule A.A.C. R14-2-608(F).

9
10 IT IS FURTHER ORDERED that Utility Source, LLC shall notify its customers of the
11 revised schedules of rates and charges authorized herein by means of an insert, in a form acceptable
12 to Staff, included in its next regularly scheduled billing.

13 IT IS FURTHER ORDERED that Utility Source, LLC shall use the depreciation rates set
14 forth in Tables E1 and E2 of Exhibit JWL to Hearing Exhibit S-1, by individual NARUC category,
15 on a going-forward basis.

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1 IT IS FURTHER ORDERED that Utility Source, LLC shall annually file as part of its annual
2 report, an affidavit with the Utilities Division attesting that the Company is current in paying its
3 property taxes in Arizona.

4 IT IS FURTHER ORDERED that this Decision shall become effective immediately.

5 BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

6
7 James H. Clemon
8 CHAIRMAN

COMMISSIONER

9 Jeffrey W. North Miller
10 COMMISSIONER

COMMISSIONER

Gary D. Rine
COMMISSIONER

11
12 IN WITNESS WHEREOF, I, DEAN S. MILLER, Interim
13 Executive Director of the Arizona Corporation Commission,
14 have hereunto set my hand and caused the official seal of the
15 Commission to be affixed at the Capitol, in the City of Phoenix,
16 this 23rd day of Jan., 2008.

17 Dean S. Miller
18 DEAN S. MILLER
19 INTERIM EXECUTIVE DIRECTOR

20 William Miller
21 DISSENT

22 R. V. [Signature]
23 DISSENT

SERVICE LIST FOR:

UTILITY SOURCE, L.L.C.

DOCKET NO.:

WS-04235A-06-0303

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